TrendMacrolytics

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FED SHADOW

Katrina and the Fed

Friday, September 2, 2005

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Expectations that the Gulf Coast disaster will deter the Fed are all wet.

As expectations for **the Fed** remaining on its steady **rate normalization** course were aggressively priced out of the market this week, particularly at the short end of the **Treasury yield curve** and in out-month **interest rate futures**, we found the response of sensitive **dollar indicators** especially notable -- and troubling. After falling abruptly to below $430 early in the week, perhaps as a signal of safe haven **dollar demand** following **Hurricane Katrina's** disruption of **Gulf Coast** infrastructure, **gold** soared above $440 in concert with the scaling back of **fed funds rate** expectations. The gold price jump, which has nearly been matched by the dollar's **forex** decline, stands as an unambiguous demonstration of the risks impacting the current policy setting. Were this resetting of expectations confirmed, the tragic losses of life and property in Katrina's wake would stand to be compounded by a damaging **inflationary** erosion of **dollar purchasing power**.

In the short run, the storm damage -- which is concentrated in but not limited to **energy** production and distribution -- amounts to a **supply shock** which will entail real economic costs in **higher prices** and **lost output**, perhaps subtracting as much as 0.5% from **GDP** in the current quarter. From a GDP accounting perspective, however, that's likely to at least be offset in the fourth quarter by rebuilding and rehabilitation activity. Over a two-quarter span, the **growth** effect is likely to be no worse than a wash, and could potentially be somewhat positive.

It's important to bear in mind, though, that even if the effects were more severe and longer lasting, the Fed would be in poor position to deal with them. **Monetary policy** does not function to rectify supply shocks. If such an event dampens **real economic activity**, the most the Fed can do by maintaining an easier policy stance is to boost **nominal growth**, *i.e.* **"money GDP."** The difference between nominal and real growth, of course, is inflation. The classic example of the Fed committing the error of accommodating a supply shock was its response to the oil price spikes of the 1970s, which helped launch an era of inflation the likes of which had not been seen in a century.

Fortunately, we see little to suggest the Fed is contemplating such a course. To the contrary, recent soundings from the central bank indicate that it has become more attuned to the potential inflationary consequences of the **oil** price increases. "High and rising energy prices were adding to pressures on overall inflation," said the minutes of the August 9 **FOMC** meeting released Tuesday. "Energy price increases would probably feed through, at least temporarily, to measures of core inflation."

In addition, **Alan Greenspan's** speech last week in **Jackson Hole** contained a little noted passage in which he essentially acknowledged that in **cutting rates** so aggressively in 2003, the Fed accepted that the likely result would be some increase in inflation. Describing the **risk management** framework which he has instituted to guide policy decisions, Greenspan said the

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low-probability risk of **deflation** "was judged a more serious threat to economic performance than the higher inflation that might ensue in the more probable scenario." He added: "Given the potentially severe consequences of deflation, the expected benefits of the unusual policy action were judged to outweigh its expected costs." Those expected costs, in terms of higher inflation, are now at hand. With the Fed acknowledging that its **policy stance** remains **accommodative** even after 250 basis points in rate hikes, it seems apparent that its primary objective at this point remains the normalization of policy so as to limit the inflationary consequences of its earlier actions. Greenspan's urgency in attaining that objective, moreover, is likely enhanced by the fact that he is now entering the last five months of his lengthy tenure as **chairman**. He no doubt is strongly motivated to take whatever action he deems necessary to limit the risk of leaving his successor with a significant inflationary breakout to cleanup.

Bottom Line: In the wake of the Katrina catastrophe, interest rate futures markets have taken nearly 40 basis points off the funds rate target expected to prevail at year end, with **December Eurodollars** now priced for an overnight rate no higher than 3.75%. Our bet is that these expectations are highly unlikely to be sustained, and that the Fed's default position remains to move to restore **equilibrium** at a rate of 25 bps per meeting, putting the year-end target at 4.25%. One caveat, however, is that given the Fed's **demand-management** focus, fallout in Katrina's aftermath more damaging than can now be anticipated might compel the Fed to make the inflationary error of shifting to a more accommodative outlook. TM